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Decision 93364 JUL 22 1981

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company for Commission approval of an energy purchase agreement between San Diego Gas & Electric Company and Kelco Division of Merck & Co., Inc. (originally filed as Advice Letter 540-E).	Application 60638 (Filed June 11, 1981)

Margaret Sullivan, Attorney at Law, for San Diego Gas & Electric Company, applicant.
Hufstedler, Miller, Carlson & Beardsley, by Burton J. Gindler, Attorney at Law, for Kelco Division of Merck & Co., Inc., interested party.
Richard D. Rosenberg, Attorney at Law, for the Commission staff.

O P I N I O N

I. Introduction

By Application (A.) 60638 filed June 11, 1981, San Diego Gas & Electric Company (SDG&E) seeks approval of an energy purchase agreement between SDG&E and the Kelco Division of Merck & Co., Inc. (Kelco). Public hearing was held July 1, 1981, before Administrative Law Judge (ALJ) Patrick J. Power. SDG&E offered the testimony of James F. Kenney, senior power engineer. Kelco offered the testimony of Don E. Conner, materials manager. The Commission staff (staff) offered the testimony of John D. Quinley, supervising utilities engineer, Alternative Energy Section, Electric Branch, Utilities Division, and Kenneth K. Chew, principal financial examiner in charge of the Energy Section of the Financial Analysis Group of the Revenue Requirements Division. The matter was submitted upon oral argument.

II. Background

Kelco is headquartered in San Diego, with major facilities in Oklahoma, among other places. Facilities at the San Diego plant perform chemical processing operations that use large amounts of steam and electricity. One San Diego operation processes kelp into refined algin products used in food processing and industrial and consumer products. The plant in Okmulgee, Oklahoma, uses a fermentation process to manufacture xanthan gum products used in similar applications. Similar fermentation facilities located at the San Diego plant were shut down for about three years due to the high cost of fuel and electric energy at that location.

Kelco employs about 500 persons in its two San Diego operations. The total payroll for employees in San Diego exceeds $10 million annually. Kelco's sales for products manufactured in San Diego exceed $30 million annually.

Due to the need for production capacity and in anticipation of this cogeneration project, Kelco has resumed operation of the fermentation plant in San Diego. The success of the cogeneration project is deemed critical to the continued operation of the facility. Without the reduced costs resulting from cogeneration Kelco intends to operate the San Diego fermentation plant only until it is able to build facilities elsewhere - outside of California.

Kelco's current energy demand requires approximately 7 MW of electrical energy and 180,000 lb. per hour of steam energy. The electrical energy is supplied by SDG&E. The steam energy is supplied in-house by four package boilers with a total capacity of 195,000 lb. per hour at 125 psig.

The proposed cogeneration facility is designed to provide the above energy requirements for Kelco's operations and to sell the excess electrical power to SDG&E. Kelco intends to install three

"Mars" gas turbine-generating sets, with each set coupled to its own waste heat boiler for steam generation of 180,000 lb. per hour at 150 psig in a simple cycle mode.

Each turbine-generator set is designed to produce approximately 6,766 kW of electricity for a gross total of 20,298 kW. Approximately 900 kW are needed to operate the cogeneration facility itself. The excess electrical power, over and above that required for in-house consumption, will be delivered to SDG&E at the interconnect facility located on Kelco's property adjacent to SDG&E's Sampson Street substation.

Kelco's San Diego plant operates 24 hours per day, seven days per week, and approximately 350 days per year. It is essential to Kelco's operations that the facilities operate full-time, without costly shutdowns. The design is based on proven criteria with only the most reliable and quality materials to be used. The estimated cost of the project is $25 million.

III. Contract Terms

The duration of the contract is 15 years from the first delivery of energy. Kelco agrees to sell whatever electric output from the plant exceeds its own requirements.

For the first five years of the agreement SDG&E will pay Kelco for energy at an hourly rate equal to 90% of SDG&E's avoided energy cost. However, at the end of each of the first five years SDG&E will calculate the average price of energy that SDG&E paid to Kelco during that year. If the average price was less that $.0625 per kWh, SDG&E will pay to Kelco, in a lump sum, the money necessary to result in an average price of $.0625 per kWh for the year. The effect of this provision is to assure Kelco a "floor" for the first five years.

For the remaining 10 years of the agreement SDG&E will pay to Kelco for energy at an hourly rate equal to 100% of SDG&E's avoided cost.

The contract provides no payment for capacity. However, it does provide that if SDG&E makes capacity payments to cogenerators or small power producers for "as delivered" energy as a result of an order by this Commission in Order Instituting Rulemaking (OIR) 2 SDG&E will make such capacity payment to Kelco.

The contract provides that it is not effective until this Commission, by decision or resolution, states that payments under to the contract terms are prudent and are recoverable in Energy Cost Adjustment Clause (ECAC) proceedings. SDG&E and Kelco urge that this Commission approve the contract as soon as possible so that approval of the president and board of directors of Merck & Co., Inc. can be obtained and the project proceed.

IV. Issues Presented

The subject matter of this proceeding raises the following issues:

1. Whether this Commission should entertain such applications for advance approval.
2. Whether the contract terms are reasonable.
3. Whether the paragraph ordered by Decision (D.) 93054 should be inserted in this contract.
4. Whether a balancing account should be applied during the first five years to track payments to Kelco and avoided costs.
5. Whether, as an alternative, SDG&E should accept the risks and retain the benefits of the contract.

Of course, the relevancy of these latter issues depends on the resolution of the former.

V. Discussion

A. Advance Approval

San Diego is not entirely clear about what specific advance approval it would like from the Commission. In its application SDG&E asked that this Commission approve the agreement and authorize recovery "of all payments made under proper administration of the Agreement through its Energy Cost Adjustment Clause." In her opening statement SDG&E's counsel stated:

> "SDG&E is not seeking approval of the entire contract but only the nonstandard rate feature of the contract during the first five years."

In her final argument she stated:

> "...SDG&E would like to see language in the final order to the effect that the Commission finds the Kelco contract to be reasonable and prudent and that the costs of SDG&E associated with its payments to Kelco will be recovered in ECAC if there has been proper administration of the contract by SDG&E."

Because the company in its testimony only addressed the first 5 years of the contract, we will conclude that its attorney's request at the beginning of the hearing reflects the company's desire, and we will therefore not examine the consistency of the contract terms during the last ten years with full avoided cost. Nothing in this decision should in any way be construed to reflect the Commission's judgment on the appropriateness of the terms for the last ten years of the contract.

The question whether such "nonstandard" contracts should be entertained for advance approval is a major policy issue pending for decision in OIR 2. SDG&E suggests that consideration of this agreement would not be a precedent that the Commission would review nonstandard contracts.

It contends that the advance review is appropriate in this proceeding because:

1. The contract requires advance approval before it becomes effective;

2. It was required to negotiate the contract within constraints outside its control;

3. Prior approval would be consistent with the treatment granted to SDG&E for standard offers under its ECAC preliminary statement Section 9-G; and

4. There is uncertainty regarding the rate recovery treatment of nonstandard contracts that will be adopted in OIR 2.

Advance approval will allegedly promote cogeneration.

Kelco agrees that advance approval is appropriate. It argues that such approval will encourage cogeneration by fostering innovation on the part of utilities and cogenerators.

In OIR 2 staff has taken the position that advance approval is inappropriate. However, in this proceeding staff witnesses did not object to prior review. Staff witness Quinley recommends that "the Commission be willing to give advance approval of negotiated contract pricing terms with qualifying facilities that differ from avoided cost based prices on contract terms." Such approval is alleged to encourage utilities to respond in an innovative manner when qualifying facilities require special contract terms, and to give the utility reasonable assurance of ECAC recovery without hindsight.

The policy decision whether to provide for advance approval will be made in the final order in OIR 2. In this decision we will proceed to address the terms of the contract relating to the first five years on their merits. However, certain comments regarding advance approval are appropriate.

First, we do not understand why Commission approval is requested prior to Merck & Co., Inc. approval. Obviously our action is useless if Kelco's parent does not approve the contract. We consider this contract at this stage only because of the apparent compelling public interest in this matter.

Second, we reject the proposition that advance approval is appropriate because there is "no benefit" to SDG&E from this contract. While it is true that the cost savings from the discounted price are

directly passed through the ratepayers, SDG&E benefits in tangible ways. For example, its fuel oil requirements are reduced. In view of the difficulty this utility has had with fuel oil procurement, such a reduction should be treasured. Further, if as available capacity is valued, SDG&E will be able to recover capacity costs through ECAC, rather than by way of rate base. In view of the financial condition of this utility, such a result seems highly beneficial to shareholders.

B. The Reasonableness Of the Contract

The focus of this proceeding has been the provision that Kelco is assured a floor in exchange for a discount from avoided cost for the first five years. SDG&E has offered a risk/benefit analysis to demonstrate that the pricing mechanism is in the best interest of its ratepayers and that the benefit of the discount outweighs the risk associated with the minimum payment guarantee. Based on certain assumptions it characterizes as "conservation", SDG&E concludes that its ratepayers could expect to save about $4.3 million if its incremental fossil fuel is oil, and about $2.2 million if its incremental fossil fuel is natural gas. Staff witness Quinley agrees that "it appears most improbable that the average avoided cost in any year will drop below the floor price of 6.25¢/kWh."

Based on SDG&E and Commission staff testimony, we conclude that the price floor to trade off the discount on avoided cost provides a reasonable method to recognize Kelco's interest in reducing risk associated with this project. While ratepayers are taking a small risk under this contract that sometime during the first five years they will pay more than the avoided cost then prevailing, this risk is offset by lower rates under the most probable outcome that avoided costs will be above this floor established for Kelco.

From SDG&E's original application, it appeared that the only significant deviation in this contract from SDG&E's standard purchase contract was in the first five years. Since the utilities sought approval in its application of the entire contract, one would assume that the rest of the contract is consistent with its standard offer. However, there is one other significant way in which this contract

is nonstandard. As stated by SDG&E witness Kenny in the following exchange with the ALJ:

> "Q: Is that the only manner in which it deviates from your standard offer as you envision it?
>
> "A: No, there are some other provisions that differ as well.
>
> "Q. Such as?
>
> "A. The one that comes to mind is a provision to reject energy from Kelco for up to 600 hours a year."

Neither SDG&E nor staff offered any analysis of the effect of this provision.

This matter is put in context by the following quotes from SDG&E's comments responding to the final staff report in OIR 2:

> "SDG&E continues to support the ability to pay at less than published costs for certain maximum hours during the year...While SDG&E does not anticipate any substantial use of this provision, prudent foresight should allow for unforeseen availability of very low (cost) power. For SDG&E this would be limited to unexpected conditions which could not be incorporated in its avoided cost calculations.
>
> "SDG&E accepts a limitation of 600 hours per year for rejection of deliveries. With respect to such rejections, SDG&E agrees to pay for capacity if not delivered but not to pay for energy not delivered up to 600 hours per year."

Of course, the final order in OIR 2 may provide for some other resolution of the curtailment issue. However, given San Diego's position on the issue, and the terms of its current standard cost offer, we find it unacceptable that this difference was not mentioned when the contract was originally tendered for review. Without any analysis in the record, we can not give advance approval for the second ten years of the contract now. San Diego can expect normal ECAC review for payments made under the second ten years of this contract.

Should any applicant seek advance approval in the future, it must identify all substantial differences between the contract

and the utility's standard offer. Failure to identify all differences in the contract for which approval is requested may cause us to deny the application.

C. Subsequent Contract Terms

By D.93054 we required that all agreements between utilities and qualifying facilities entered into after the date of the decision (May 19, 1981) contain the following provision:

> "The Agreement may be amended, at the written option of the Seller, to conform to the final decision and order which is issued by the California Public Utilities Commission in connection with Order Instituting Rulemaking No. 2 and which affects the utility's purchase of electric power from cogeneration and small power production facilities. To exercise this option, Seller must deliver to the purchasing Utility a written notice of election to amend within 90 days of the effective date of the final decision and order in OIR No. 2. Said amendment shall be effective as of the effective date of this Agreement or as of such other date as may be agreed upon by the Seller and the Utility."

SDG&E and Southen California Edison Company have petitioned the Commission for rehearing of D.93054. Their petitions are pending. SDG&E and Kelco have asked that the provision not be required in their contract. Staff concurs.

Because the contract was reached before D. 93054 was issued, and because neither party wishes to reopen the negotiations on this issue, we will not require the clause in this case. The current contract includes a provision that a capacity payment will be provided should OIR 2 provisions on capacity apply to Kelco. We conclude that the OIR clause is not necessary in this case. It should be clear to Kelco that by declining to include this provision that it is foregoing potentially advantageous terms.

Staff witness Chew proposes that this Commission require modification of the contract as follows:

> "SDG&E should be required to maintain a memorandum account known as the Avoided Cost Tracking Account (ACTA) to account for the cost of energy purchased from Kelco. The balance in the ACTA would be the accumulated difference, plus/minus, between the full avoided costs and the actual payments made to Kelco. At the end of the fifth year, or any time thereafter when the balance in the ACTA is zero or positive (Avoided costs ≥ Payments), then the contract can go into 100% avoided cost pricing."

Staff witness Quinley states that he has requested utilities to consider such an approach in future negotiated agreements. He thinks the risk of overpayment is so slight that a balancing account is not necessary in this case.

Kelco opposes Chew's proposal. As stated in its closing argument:

> "Under the contract we might get, in an unlikely situation, a little bit more than full avoided cost. Over the first five years, because of the floor, we're accepting 90 percent of avoided cost, and that was the trade-off that the parties made.
>
> "Under Mr. Chew's suggestion we will never get more than 100 percent of avoided cost.
>
> "That would tend to defeat the negotiation of an arrangement which is in the contract which is most likely to benefit the ratepayers of SDG&E because its most likely they will have to pay less than full avoided cost under the very scenarios that have been presented. And it is a very unlikely event they will have to pay more."

It argues that in such circumstances there is no incentive to negotiate for less than full avoided cost.

We agree that the balancing account concept should not be applied in this proceeding. These parties have rigorously worked out the price-risk tradeoff. Such interference at this stage might threaten the future of the project. SDG&E and other utilities are free to consider the balancing account concept in subsequent negotiations.

Chew also offered, as an alternate recommendation, that this Commission might provide for SDG&E to accept the risks of the contract and retain the benefits for its shareholders. SDG&E requested and was granted additional time to comment on Chew's alternate. No comment was received. For purposes of future analysis, we direct SDG&E to file within 30 days a letter explaining its position on Chew's proposal.

Conclusion

We have considered the merits of the nonstandard rate feature during the first five years of the contract and found the contract to be reasonable. We have not examined whether the contract terms for the last ten years are consistent with full avoided costs. The appropriateness of contract terms for the last ten years will be examined when revenue recovery is requested in year six of the contract. This is the same procedure that will be followed with any other purchase power contract entered into by SDG&E with a qualifying facility and not approved in advance by the Commission.

Findings of Fact

1. Kelco's San Diego operations are suitable for a cogeneration project.

2. The size of such a project is about 20 to 24 MW.

3. Kelco's own energy requirements are about 7 MW.

4. The remaining output of the project is available for sale to SDG&E.

5. Kelco and SDG&E have agreed to contract terms regarding the purchase of the excess energy output of the project for 15 years.

6. The contract provides for the first five years payment to Kelco at 90% of avoided energy costs, or a yearly average rate of $.0625/kWh, whichever is higher.

7. For the remaining ten years, the contract provides payment to Kelco at 100% of avoided cost, but with different curtailment features from SDG&E's standard purchase power offer.

8. No evaluation was presented by the company on the merits of the contract for the last ten years.

9. The contract provision adopted by D.93054 need not apply to this contract.

10. Insertion of a balancing account provision in the contract might precipitate protracted negotiations, delaying, or defeating the project.

11. SDG&E did not respond to witness Chew's proposal that the company bear all the risks and receive all the benefits of the contract.

Conclusion of Law

1. The pricing provision applicable to the first five years of the contract is reasonable, and should therefore be approved.

ORDER

IT IS ORDERED that:

1. A.60638 is granted only insofar as approval is sought for the pricing terms of the first five years of the contract.

2. SDG&E shall file within 30 days a letter explaining its position on Chew's proposal that it accept the risks of the contract and retain the benefits for its shareholders.

This order becomes effective 30 days from today.

Dated JUL 22 1981, at San Francisco, California.

I abstain.
John E. Bryson
August 18, 1981

John E. Bryson
President
Richard D. Gravelle
Leonard M. Grimes
Victor Calvo
Priscilla C. Grew

I abstain.
Priscilla C. Grew
August 18, 1981.